Box A

Covered Bonds

Covered bonds are bonds secured by a pool of high-quality assets on the issuing financial institution's balance sheet. The main feature of covered bonds is that if the issuer can no longer service the periodic bond payments, investors have a preferential claim on this pool of assets and the associated cash flows. If the cover assets are not sufficient to meet the bond payments in full, covered bondholders also have an unsecured claim on the issuer to recover any shortfall. In that case they would stand on an equal footing with the issuer's other unsecured creditors. This is known as dual recourse.

The covered bond market is large, with a total global amount outstanding of about €2.2 trillion in 2010. Around 300 institutions in over 30 countries have issued covered bonds. The bulk of covered bonds, around 90 per cent, have been issued by countries in the euro area, though firms have recently started to do so in some other countries, including Canada, New Zealand, South Korea, United Kingdom and the United States. In the euro area, the covered bond market is roughly 40 per cent of the size of the sovereign bond market.

Covered bonds can be regulated by a specific legal framework or on a contractual basis using general law, though the majority are issued under special legal frameworks. Either way, all covered bonds are designed to provide maximum investor protection. The legal frameworks vary considerably across countries, but they typically determine:

- which institutions are allowed to issue covered bonds;
- what type of assets can be used to secure the covered bonds;
- how the assets are protected and made available exclusively to investors if the issuer becomes insolvent;
- how the issuer must manage the pool of assets by over-collateralising and by replacing impaired or matured assets; and
- which regulatory authority enforces compliance with the covered bond law.

Because of strict regulations and the two-fold protection of investors' interests, covered bonds are considered to be the safest form of bank debt. As a result, they typically carry a higher credit rating than that of their issuer, and allow the issuer to access cheaper and more stable long-term funding from the wholesale debt markets.

The funding advantages of covered bonds are currently attracting attention in Australia. In December 2010, the Australian Government announced that it will establish a legal framework that will permit all authorised deposit-taking institutions (ADIs) to issue covered bonds. Currently, Australian ADIs are not permitted to issue covered bonds because covered bondholders would have preferential access to an ADI's assets, thereby subordinating other unsecured creditors, like ordinary depositors. This would conflict with the *Banking Act 1959*, which enshrines the principle of depositor preference under which, if an ADI is wound up, all of its assets in Australia are made available to meet the ADI's deposit liabilities in Australia in priority to other liabilities of the ADI.

Countries that have adopted covered bond regulations have managed depositor subordination differently. Up until about a decade ago, issuance of covered bonds across Europe was restricted mostly to specialised credit institutions that did not take deposits. More recently, however, some countries have begun to permit deposit-taking institutions to issue covered bonds, for example, Germany in 2005.

Countries that have only recently begun to permit covered bonds have tended to manage the subordination of depositors and other creditors by setting limits on the issuance of covered bonds. Regulations in Canada and rules proposed in the US Covered Bond Act limit covered bond issuance to 4 per cent of a deposit-taker's assets (in Canada) or liabilities (in the United States). Formal issuance caps have also been prescribed in the United Kingdom: the UK Financial Services Authority discusses all covered bond and other 'asset encumbrance' plans with issuers and can impose both issuance caps and higher capital charges. On the other hand, there are few such limits elsewhere in Europe and no common European regulatory limits. Italian law imposes formal caps on the amount of assets that can be reserved for secured creditors, but the limit is greater the higher the bank's capital ratio, and does not apply if capital ratios exceed certain thresholds. In most European countries, prudential supervisors must prevent cover pools from excessively encumbering bank assets by exercising their discretion in their normal oversight of institutions.

The secured nature of covered bonds means they combine some characteristics of securitisation with those of traditional senior unsecured bank bonds. However, they differ from securitisation in a number of ways. Unlike securitisation, the issuer of a covered bond can be a regulated credit institution, not a special purpose vehicle, and thus be subject to prudential oversight. The assets funded by the covered bond remain on the consolidated balance sheet of the issuer and form a bankruptcy-remote cover pool. However, unlike for asset-backed securities where the pool of assets typically does not change, issuers must remove non-performing or matured assets. They must also provide extra collateral as security in case the value of the assets depreciates during the term of the covered bond. Investors therefore bear little risk that assets securing a covered bond might become impaired. They are also not exposed to the prepayment risk that is inherent in the amortising payment structure of most asset-backed securities, since covered bonds are issued in the form of plain-vanilla fixed income securities that pay a periodic coupon and redeem all principal at a specific maturity. Finally, covered bonds are not structured with several tranches that carry different risk features and credit ratings like those in typical asset-backed securities.

Covered bonds were not immune from the effects of the financial crisis but did prove more resilient to severe market stress and, with European Central Bank (ECB) support, have recovered faster than other wholesale funding instruments, such as asset-backed securities and unsecured bank debt. The relative resilience of covered bonds is to be expected: the dual recourse and cover pool replacement provisions put covered bond investors in a better position than those holding asset-backed securities and unsecured debt. The European mortgages that typically back covered bonds also became less distressed than the US mortgages that backed many US residential mortgage-backed securities (RMBS). Nonetheless, despite providing more safety to investors, covered bond issuers' access to debt markets became seriously disrupted during the crisis, suggesting that the robustness of covered bonds should not be overstated.

Before the financial crisis, European covered bonds traded at a very small margin over the benchmark reference euro swap rate, with little variation according to where in Europe they were issued. These spreads widened substantially after the collapse of Lehman Brothers in September 2008, and market conditions deteriorated further in subsequent months; spreads for German and French covered bonds peaked at around 100 and 140 basis points respectively in early 2009, while spreads for Spanish covered bonds peaked at around 180 basis points. Furthermore, issuance in primary markets stalled and liquidity became poor. At the same time, however, equivalent spreads for unsecured bank debt in the euro area rose by a lot more, peaking at about 250 basis points on average in 2009, while spreads for prime RMBS peaked at around 500 basis points.

The disruptions to covered bond markets prompted the ECB in May 2009 to put in place a program to purchase up to €60 billion of European covered bonds in the primary and secondary markets. This program was completed in June 2010. The aim of the program was to improve funding conditions for institutions issuing covered bonds, and to improve liquidity in the secondary market. The program largely achieved its goals: covered bond spreads narrowed substantially after the program was announced, while total gross issuance of covered bonds in 2010 increased by 20 per cent from 2009, to over €350 billion, a near-record amount. Issuance since the start of this year has also been at a record pace.

The net effect of increased covered bond issuance on banks' funding costs is uncertain. By committing bank assets to secure payments on covered bonds, unsecured senior bonds as well as more junior debt securities are effectively lowered in rank, so investors in them might demand higher returns to the extent that the impact on credit quality of those securities is perceived as material. Total wholesale funding costs therefore might not fall. European banks currently face higher costs of issuing senior debt, but it is not clear how much of the increase stems from the record pace of covered bond issuance, versus investor concerns about recent European Union proposals to change the treatment of senior debt of a distressed bank. Depositors are also subordinated, but are partly protected from this risk by deposit insurance schemes. While recognising that covered bonds subordinate other claims, banks argue that, provided issuance is not excessive, the capacity to issue covered bonds provides access to an additional and more robust source of funding.